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DEPARTMENT PASS FEDERAL RESERVE BOARD

E.O. 1L652: GDS
TAGS: EFIN, UK, PGOV. TINT
SUBJECT: A NEW FINANCIAL AND INDUSTRIAL ROLE FOR
CALLAGHAN?

REFS: (A) LONDON 571; (B) LONDON 662; (C) LONDON 605

SUMMARY: MEDIA AND PRIVATE SPECULATION ABOUT THE SIGNI-
FICANCE OF PRIME MINISTER CALLAGHAN'S REPORTED "NEW
ROLE" IN FINANCIAL AND INDUSTRIAL POLICY MATTERS (REF A)
HAS BEEN CONFUSING AND, TO SOME EXTENT, CONFLICTING.
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SOME OBSERVERS HAVE ASSERTED THAT THESE REPORTS REPRESENT
AN IMPORTANT POWER SHIFT OR THAT CALLAGHAN DESIRES TO RE-
CEIVE POLITICAL CREDIT NOW THAT ECONOMIC PROSPECTS HAVE
IMPROVED; OTHERS BELIEVE THE MEDIA GREATLY EXAGGERATED
THE IMPORTANCE OF A ROUTINE BACKGROUND BRIEFING OR THAT
THE PM FLOATED A TRIAL BALLOON TO TEST PUBLIC REACTION
TO A POSSIBLE REORGANIZATION OF THE GOVERNMENT'S ECONOM-

IC DECISION-MAKING PROCESS. THERE MAY BE AN ELEMENT OF TRUTH IN ALL OF THESE THEORIES, ALTHOUGH THE SIGNIFICANCE OF THE PRESS BRIEFING WAS EXAGGERATED. EVEN IF EXAGGERATED, HOWEVER, THE SPECULATION HAS TENDED TO UNDERMINE BOTH CHANCELLOR HEALEY AND INDUSTRY SECRETARY VARLEY AND TO UNDERScore CALLAGHAN'S DISENCHANTMENT WITH TREASURY AND THE BANK OF ENGLAND. STANDING ALONE, HOWEVER, THESE REPORTS ARE CLEARLY OF GREATER POLITICAL THAN ECONOMIC SIGNIFICANCE. IT REMAINS TO BE SEEN IF THE PRIME MINISTER WILL CONTINUE TO BRING THE ENTIRE CABINET INTO THE NEXT BUDGETARY DECISION-MAKING PROCESS, AS HE DID IN NOVEMBER-DECEMBER. IT DOES SEEM LIKELY THAT THE "NEW ROLE" WILL CONTINUE TO GIVE AN INCREASED POSSIBILITY FOR PRIVATE ADVISERS TO INFLUENCE THE PRIME MINISTER'S DECISION-MAKING PROCESS, AS HAROLD LEVER DID IN THE RECENT RUN-UP TO THE STERLING BALANCES DECISION. END SUMMARY.

1. THE PRESS, OTHER MEDIA AND PRIVATE OBSERVERS INITIALLY TREATED JANUARY 12 REPORTS -- ORIGINATING AT A NUMBER 10 BACKGROUND BRIEFING FOR THE PRESS -- THAT PRIME MINISTER CALLAGHAN WOULD BE TAKING A CLOSER INTEREST IN INDUSTRIAL POLICY AND KEEPING A CLOSE WATCH ON THE POUND AS A STINGING REBUKE FOR INDUSTRY SECRETARY VARLEY AND CHANCELLOR HEALEY (E.G., THE EVENING NEWS HEADLINED: "SLAP FOR HEALEY" -- REF A). THESE REPORTS ALSO HYPOTHESIZED THAT THE BACKGROUNDER PORTENDED A MAJOR SHIFT IN THE FORMULATION OF GOVERNMENT ECONOMIC POLICY.

2. THE FOLLOWING DAY CALLAGHAN TOLD QUESTIONERS IN CONFIDENTIAL

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MONS THAT THEY SHOULD NOT BELIEVE ALL THEY READ IN THE PAPERS (REF B). SUBSEQUENTLY, NUMBER 10 PASSED THE WORD THAT WHILE THE "TONE" OF THESE REPORTS HAD BEEN INCORRECT AND CALLAGHAN WAS NOT PLOTTING AGAINST HEALEY OR VARLEY, THE GIST OF THE BACKGROUNDER HAD BEEN ACCURATE.

3. RECONSTRUCTING EVENTS FROM LATER, IN-DEPTH PRESS ACCOUNTS AND INFORMATION FROM SOURCES AT NUMBER 10, IT APPEARS THE STORIES AROSE FROM A SOMEWHAT CASUAL RESPONSE BY THE PM'S PRESS SECRETARY, TOM MCCAFFREY, TO A QUESTION DURING A ROUTINE MORNING BACKGROUNDER. MCCAFFREY APPARENTLY TOLD HIS INTERLOCUTOR THAT THE PM INTENDED TO TAKE A CLOSER INTEREST IN ECONOMIC AFFAIRS. ELABORATING A REPLY TO A FOLLOW-ON QUESTION, HE SUGGESTED THAT INDUSTRIAL POLICY AND THE STATE OF THE POUND WOULD BE TWO OF THE PM'S PRINCIPAL INTERESTS. THESE POINTS WERE REPEATED IN THE AFTERNOON BRIEFING, AT WHICH TIME MCCAFFREY ADDED THAT THE PM WOULD HAVE REGULAR JOINT MEETINGS WITH THE CHANCELLOR AND THE GOVERNOR OF THE BANK OF ENGLAND. NONE OF THIS

WAS INTENDED TO BE A SPECIAL ANNOUNCEMENT, AND NUMBER 10
WAS SURPRISED BY THE EXTENT AND TENOR OF THE MEDIA REAC-
TION, HENCE CALLAGHAN'S DEMURRAL IN COMMONS THE FOLLOWING
DAY.

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4. AS THE STORY REVERBERATED, VARIOUS INFERENCES AS TO
ITS SIGNIFICANCE WERE DRAWN. INITIAL THEORIES STRESSED
THE REBUKE ANGLE AND SUGGESTED THAT CALLAGHAN DESIRED TO
CLAIM CREDIT FOR THE SUCCESSFUL CONCLUSION OF THE IMF AND
BASEL NEGOTIATIONS AND FOR ANTICIPATED FAVORABLE DEVELOP-
MENTS IN THE ECONOMY. LESS SUPERFICIAL OBSERVERS, WHILE
NOT ENTIRELY DISCOUNTING THE FIRST TWO THEORIES, EM-
PHASIZED THAT THE ANNOUNCEMENT REFLECTED THE PM'S DIS-
SATISFACTION WITH THE PERFORMANCE OF THE TREASURY AND THE

BANK OF ENGLAND, AN ATTITUDE THAT HAS BEEN DISCERNIBLE
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AT LEAST SINCE OCTOBER AND MAY TRACE ITS ORIGINS TO THE TIME WHEN CALLAGHAN WAS CHANCELLOR. STILL OTHERS SUGGESTED THAT THE PM'S NEW ROLE WAS PART OF A DRAMATIC INITIATIVE TO RESTORE BUSINESS CONFIDENCE AND GET THE ECONOMY MOVING. THIS INTERPRETATION WAS BUTTRESSED BY CALLAGHAN'S DECISION (BY NO MEANS UNPRECEDENTED) TO CHAIR THE FEBRUARY 2 NEDO INDUSTRIAL STRATEGY MEETING AND BY REPORTS THAT HE WAS CONSIDERING CALLING A NATIONAL INDUSTRIAL CONFERENCE TO SPEED THE REGENERATION OF BRITISH INDUSTRY.

5. AS THE DUST BEGAN TO SETTLE (AND THE BACKGROUND BOYS AT NUMBER 10 BEGAN TO EXPLAIN THE EVENTS TO SELECTED MEMBERS OF THE PRESS), TWO OTHER THEORIES EMERGED. ONE SUGGESTED THAT WHILE THE PM PLANNED TO DEVOTE MORE TIME TO ECONOMIC ISSUES, THE IMPUTED SIGNIFICANCE OF A RATHER CASUAL BRIEFING WAS BLOWN OUT OF ALL PROPORTION. THE OTHER THEORY SUGGESTED THAT THE ENTIRE EXERCISE HAD BEEN PLANNED TO LAUNCH A TRIAL BALLOON TO TEST THE POLITICAL ATMOSPHERE FOR A POSSIBLE REORGANIZATION OF THE GOVERNMENT'S ECONOMIC POLICY-MAKING PROCESS. WHERE DOES THE TRUTH LIE? IF WE WERE FACED WITH A MULTIPLE CHOICE QUESTION, WE WOULD SELECT "ALL OF THE ABOVE"; IF THAT WAS NOT ONE OF THE OPTIONS, WE WOULD CHOOSE THE "I WANT MORE OF THE CREDIT" THESIS LINKED WITH EXAGGERATION. OUR SOURCES AT NUMBER 10 ACKNOWLEDGE THAT MCCAFFREY WAS A BIT TOO OFFHAND IN HIS HANDLING OF THE QUESTIONS, BUT ARGUE THAT THE PRESS GREATLY EXAGGERATED THE IMPORTANCE OF HIS REMARKS. IRRESPECTIVE OF THE PRESS SECRETARY'S INTENT, THESE EVENTS HAVE UNDERMINED HEALEY AND VARLEY IN THE PUBLIC EYE.

6. A BIT OF BACKGROUND. SINCE OCTOBER, THE PRIME MINISTER'S ANNOYANCE, MISTRUST OR WHAT HAVE YOU TOWARDS THE TREASURY AND THE BANK OF ENGLAND HAVE BEEN MADE PAINFULLY MANIFEST IN PUBLIC. EXAMPLES INCLUDE HIS OCTOBER 25 TV
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INTERVIEW ON PANORAMA, WHEN SPEAKING OF FOREIGN EXCHANGE MARKETS HE SAID, "THERE WAS A MAN IN THE BANK OF ENGLAND ABOUT 15 YEARS AGO WHO USED TO GET IT VERY RIGHT BUT HE ALAS HAS RETIRED NOW AND I THINK IT IS A VERY DIFFICULT THING TO DO...THE FORECASTS TEND TO BE SELF-FULFILLING

AND THIS IS VERY DAMAGING I THINK TO US AT THE PRESENT TIME BECAUSE ALL THE FORECASTS ARE BAD FORECASTS." AND THEN AFTER SAYING HE WOULD LOVE TO GET RID OF STERLING'S RESERVE CURRENCY ROLE, HE ADDED, "I AM NOT SURE THAT EVERYBODY IN THE TREASURY WOULD OR MAYBE IN THE BANK, I DON'T KNOW BUT FROM BRITAIN'S POINT OF VIEW I SEE NO PARTICULAR ADVANTAGE OF BEING A RESERVE CURRENCY AT ALL." THESE ARE SIMPLY OFFERED AS EXAMPLES, BUT THEY DO NOT RING OF STRONG CONFIDENCE IN THE TWO INSTITUTIONS MENTIONED.

7. FURTHER, DURING THE CHANCELLOR'S EXTREMELY LENGTHY DISCUSSIONS WITH THE IMF NEGOTIATING TEAM, THE PRIME MINISTER REPORTEDLY TIED HEALEY'S HANDS DURING THE INITIAL TWO WEEKS, GIVING HIM VERY LITTLE LATITUDE TO DISCUSS POLICY CHANGES. THEN WHEN PROPOSED BUDGET CUTS DRAWN UP BY H.M. TREASURY WERE DEBATED IN CABINET, RATHER THAN SUPPORT THE CHANCELLOR, THE PRIME MINISTER REMAINED LARGELY SILENT, LEAVING HEALEY TO FEND OFF THE ATTACKS AND PRESS LEAKS OF THE MINISTERS RESPONSIBLE OF THE SPENDING DEPARTMENTS.

8. BRINGING OTHER MINISTERS INTO A DECISIONMAKING PROCESS PREVIOUSLY RESERVED TO THE PRIME MINISTER AND THE CHANCELLOR HAS SET A PRECEDENT THAT MAY BE HARD TO REVERSE. SOME OBSERVERS REPORT THAT THE PRIME MINISTER ALL ALONG INTENDED TO SUPPORT THE CHANCELLOR AND WAS MERELY ALLOWING HIS OTHER COLLEAGUES TO VENT THEIR SPLEEN RATHER THAN RESIGN IN FRUSTRATION. OTHER OBSERVERS CONSIDER THAT THE PRIME MINISTER ONLY SUPPORTED HEALEY AFTER IT BECAME ABSOLUTELY CLEAR THAT THE IMF WOULD NOT SOFTEN ITS CONDITIONS. IN ANY CASE, IT WAS NOT UNTIL WELL PAST THE 11TH HOUR THAT THE PM CAME TO THE CHANCELLOR'S ASSISTANCE, LEAVING HEALEY CONFIDENTIAL

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LABOR PARTY, FROM THE TRADE UNIONS AND FROM HIS OTHER
PARLIAMENTARY COLLEAGUES.

9. TURNING TO INDUSTRIAL POLICY, THERE HAVE BEEN INCREAS-
ING REPORTS THAT THE NEW INDUSTRIAL STRATEGY IS BECOMING
BOGGED DOWN IN BUREAUCRATIC INFIGHTING, DON'T ROCK THE
BOATISM AND LACK OF INDUSTRIAL EXPERTISE (SEE REF C FOR
DETAILS). THE PM IN HIS INITIAL SPEECH TO THE NATION, AND
WITH FAR GREATER ELABORATION AT THE PARLIAMENTARY LABOUR
PARTY CONFERENCE IN SEPTEMBER, HAS STRESSED THE NEED FOR
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REGENERATION OF BRITISH INDUSTRY. INDEED, IN THE ABOVE
MENTIONED TV PROGRAM WHILE DISCUSSING THE VALUE OF STER-
LING, HE STRESSED "WE HAVE GOT TO KEEP OUR EYE ON THE LONG
VIEW, AND THE LONG VIEW IS REGENERATING BRITISH INDUSTRY,
MANUFACTURING INDUSTRY ESPECIALLY."

10. WHAT DOES THE PRIME MINISTER'S NEW ROLE MEAN. NO ONE
IS REALLY SURE, BUT ITS IMPACT WILL CERTAINLY BE MORE POLI-
TICAL THAN ECONOMIC. WITH THE \$850 MILLION US AND GERMAN
SWAP-CREDIT LINE, THE \$3.9 BILLION IMF LOAN, AND THE \$3

BILLION BASLE FACILITY, THE UK HAS HAD \$7.75 BILLION MADE
AVAILABLE DURING THE PAST MONTH, ALTHOUGH NOT ALL WILL BE

DRAWN UPON AT THE SAME TIME. THE TWIN ACHIEVEMENTS OF AN IMF LOAN AND THE OFFICIAL STERLING BALANCE FACILITY HAVE GIVEN THE FOREIGN EXCHANGE MARKETS A BETTER TONE. THE STAGE IS SET FOR STEADY IMPROVEMENT IN UK ECONOMIC GROWTH AND BALANCE OF PAYMENTS PERFORMANCE, ESPECIALLY THE LATTER WITH NORTH SEA OIL COMING PROGRESSIVELY ON STREAM DURING THE NEXT 3 YEARS.

11. THERE IS OF COURSE NO GUARANTEE THAT THE UK PROBLEMS WILL BE PUT RIGHT NOR THAT THE UNIONS WILL BE REASONABLE IN SHOWING RESTRAINT IN THE THIRD ROUND OF PAY POLICY, BUT IMF CONDITIONALITY SHOULD HELP. IF MEANINGFUL PROGRESS CANNOT BE MADE NOW, IT IS UNLIKELY THAT IT WILL BE FORTHCOMING IN THE FORESEEABLE FUTURE. WITH THE MAJOR BATTLES AND THE BLOOD LETTING NOW IN THE PAST, THE PM IS MOVING TO CENTER STAGE IN ORDER TO CLAIM A MAJOR SHARE OF WHATEVER CREDIT MAY BE FORTHCOMING FROM FUTURE DEVELOPMENTS. HOWEVER, AS A POLITICIAN CALLAGHAN MAY NOT WISH TO GET TOO

FAR OUT IN FRONT, LEST HE TAKE ALL THE BLAME FOR ANY FAILURES. THE JANUARY 18 EVENING STANDARD PUT IT THUS: "IT LOOKS AS IF CAPTAIN CALLAGHAN LOOKED OUT OF HIS CABIN PORT HOLE, SAW THE STORM HAD ABATED AND SMOOTHER WATER LAY
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AHEAD, AND STRODE PURPOSEFULLY TO THE BRIDGE CALLING 'TLL TAKE THE WHEEL NOW HELMSMAN.'" MANY OFFICIALS IN THE TREASURY AND BANK OF ENGLAND MUST SHARE THIS ASSESSMENT.

12. THIS SAID, THE CHANCELLOR HAS LOST CREDIBILITY DURING THE PAST YEAR BOTH WITH THE CABINET, PARLIAMENTARY COLLEAGUES AND WITH THE GENERAL PUBLIC. BY WAY OF EXAMPLE, THE VAROOSHKA POLITICAL CARTOON STRIP IN THE GUARDIAN ON JANUARY 17 SHOWS HEALEY SAYING, "GOOD TIMES ARE COMING" TO THE VOLUPTUOUS MISS VAROOSHKA WHO REPLIES, "WHAT? FROM YOU? PULL ANOTHER ONE. AFTER YEARS OF YOUR DECEITS... YOUR FALSE PREDICTIONS...THERE IS NOTHING YOU CAN SAY TO MAKE ME BELIEVE GOOD TIMES ARE COMING..." HEALEY: "I AM BEING DOWNGRADED BY THE PRIME MINISTER SO AS HE CAN TAKE THE CREDIT." MISS VAROOSHKA: "GOOD TIMES ARE COMING."

13. HEALEY IS WIDELY BELIEVED TO BE GOING TO SWAP JOBS WITH FOREIGN SECRETARY ANTHONY CROSLAND AT SOME POINT AFTER APRIL BUDGET. CROSLAND IS CITED AS BEING THE CABINET MEMBER WHO WAS MOST ANTAGONISTIC TO HEALEY'S DECEMBER BUDGET CUTS, REQUIRED AS PART OF THE IMF PACKAGE. THE SWAP OF JOBS, IF IT COMES OFF, WILL CREATE AN INTERESTING SITUATION, WITH THE MAIN OPPONENT OF THE CUTS CHARGED WITH IMPLEMENTING THEM. PRIOR TO THIS, HOWEVER, IT REMAINS TO BE SEEN HOW MUCH FREEDOM HEALEY WILL BE GIVEN IN THE PREP-

ARATION OF HIS APRIL BUDGET, IN WHICH HE PERSONALLY WOULD
LIKE TO CUT DIRECT TAXES AT BOTH THE UPPER AND LOWER ENDS
OF THE INCOME RANGE. PHRASED DIFFERENTLY, WILL THE PM
ONCE AGAIN THROW PROSPECTIVE BUDGET CHANGES OPEN FOR
LENGTHY DISCUSSION BY THE ENTIRE CABINET OR--AS IN
BUDGETS PRIOR TO THE DECEMBER EXERCISE--WILL THE CHANCEL-
LOR BE ALLOWED CONSIDERABLE LATITUDE AND FREEDOM OF ACTION?

14. IT DOES APPEAR THAT THE PRIME MINISTER INTENDS TO
HAVE MORE FREQUENT MEETINGS WITH THE CHANCELLOR AND THE
GOVERNOR OF THE BANK OF ENGLAND TO MONITOR MORE CLOSELY
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FINANCIAL AND EXCHANGE RATE POLICY. THROUGH NEDO, WHICH HE WILL PERIODICALLY CHAIR, HE INTENDS TO INJECT GREATER EMPHASIS ON "GETTING ON WITH THE JOB" OF INDUSTRIAL REGENERATION. HOWEVER, IT REMAINS TO BE SEEN WHETHER THE NECESSARY INCREASED INDUSTRIAL INVESTMENT AND IMPROVED PERFORMANCE WILL IN FACT TAKE PLACE.

15. REPORTS VARY CONCERNING THE PRIME MINISTER'S COMPETENCE IN THE FINANCIAL, FOREIGN EXCHANGE, AND INDUSTRIAL

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FIELDS. REFERENCE TO CALLAGHAN'S PAST PERFORMANCE AS CHANCELLOR IS MORE DEPRECATORY THAN FLATTERING. IT SEEMS UNLIKELY THAT HE WILL TINKER WITH THE NUTS AND BOLTS, ALTHOUGH NOW THAT HE HAS LET IT BE KNOWN THAT HE INTENDS TO PLAY A MORE DIRECT AND SUPERVISORY ROLE, HE WILL BE MORE HESITANT THAN HE WOULD HAVE BEEN IN THE PAST TO ACQUIESCE IN OR SANCTION POLICIES OR POLITICAL INITIATIVES WHICH IF UNSUCCESSFUL, COULD BE BLAMED ON HIM RATHER THAN ON THE MINISTERS CONCERNED. THE RELATIVE DOWNGRADING OF THE ADVICE AND ROLE OF THE TREASURY (STILL THE STRONGEST SINGLE DEPARTMENT) AND THE BANK OF ENGLAND AND THE CENSURE THAT THEY HAVE RECEIVED FROM CALLAGHAN, DIRECTLY IN PUBLIC COMMENTS OR INDIRECTLY THROUGH LEAKS TO THE PRESS, WOULD TEND TO WEAKEN ANY OPPOSING ROLE THAT EITHER INSTITUTION MIGHT SEEK TO PLAY. IN PARTICULAR, THE BALANCE HAS BEEN TILTED AT LEAST A LITTLE IN FAVOR OF SPENDING DEPARTMENTS WITH A LESSENING OF THE WEIGHT OF THE TREASURY AS A RESTRAINING FORCE. IN ADDITION, THE PRIME MINISTER MAY BE MORE AMENABLE TO ADVICE OFFERED PRIVATELY FROM OUTSIDERS OR MINISTERS WITHOUT DEPARTMENTAL RESPONSIBILITY, SUCH AS THE ROLE PLAYED BY HAROLD LEVER DURING THE RUN UP TO THE STERLING BALANCE DISCUSSIONS.

16. THE FIRST PARLIAMENTARY EXCHANGE OF ANY SUBSTANCE WITH THE PM IN HIS NEW ROLE CAME ON JANUARY 18, WHEN HE SUGGESTED THAT A QUESTION ON INTEREST RATES SHOULD BE DIRECTED AT THE CHANCELLOR. THERE WERE TORY CRIES OF "YOU'RE IN CHARGE." CALLAGHAN THEN PROVIDED WHAT MAY COME TO BE THE MOST ACCURATE ASSESSMENT OF HIS NEW ROLE: "I KNOW I WON'T GET THAT ALBATROSS OFF MY NECK" AND PREDICTED THAT HE WOULD BE PURSUED BY CHARGES ABOUT THE IMPLICATIONS OF HIS EXPANDED ROLE, WHETHER TRUE OR NOT. ARMSTRONG

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